Internal Revenue Service

memorandum

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Br2:JMPanitch

date: JUL 12 1988

to: District Counsel, Brooklyn CC:BRK
Attn: Jody S. Tancer

from: Director, Tax Litigation Division CC:TL

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subject: [redacted]
T.C. Dkt No. [redacted]

The following analysis responds to your request for technical advice dated April 8, 1987.

ISSUE

Whether a taxpayer is entitled to claim Schedule C losses (and the net operating loss and investment credit carrybacks and carryovers resulting therefrom) on his individual return, where taxpayer's wholly-owned North Carolina corporation generated such losses during a period when its corporate charter was suspended.

CONCLUSION

Where state law sanctions do not result in nonrecognition of the corporation under state law, federal law recognizes the corporation as a separate taxable entity. Charter suspension does not result in nonrecognition of a corporation's existence under North Carolina law. Thus, [redacted] was a distinct entity taxable as a corporation during the years at issue under federal law.

FACTS

Petitioner, [redacted], was the sole proprietor of a [redacted] manufacturing business, [redacted], which was incorporated in North Carolina in [redacted]. The State of North Carolina suspended [redacted] corporate charter on [redacted], pursuant to North Carolina General Statutes § 105-230 (1985). After North Carolina suspended [redacted] corporate charter, [redacted] continued to hold [redacted] out to the public (and to operate it) as a corporation. Petitioners claimed the losses incurred in the [redacted] business on Schedule C for the taxable years [redacted] and [redacted].

ANALYSIS:

The Supreme Court held in Moline Properties, Inc. v. Commissioner, 319 U.S. 436, 438-39 (1943):

> The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity....
>
> To this rule there are recognized exceptions.... In general, in matters relating to the revenue, the corporate form may be disregarded where it is a sham or unreal. In such situations the form is a bald and mischievous fiction....

Moline has generally been interpreted to mean that an entity recognized as a corporation under state law which has been incorporated for a valid business (nontax) purpose or which, after incorporation, conducts business, will be taxed as a corporation unless merely a sham. E.g., National Carbide Corp. v. Commissioner, 336 U.S. 422, 431-432 (1949); Bolger v. Commissioner, 59 T.C. 760, 766-767 (1973).1/ Alternatively, where an entity has not been incorporated or where an incorporated entity's corporate charter has been revoked, the courts take guidance from Morrissey v. Commissioner, 296 U.S. 344 (1935) and Treas. Reg. § 301.7701-2. Under this regime, the entity's status for tax purposes depends on whether the entity is more like an association (taxable as a corporation) or more like a sole proprietorship, a partnership, or a trust. E.g., Knoxville Truck Sales and Service, Inc. v. Commissioner, 10 T.C. 616, 621-22 (1948). Thus, assuming that [redacted] was incorporated for a legitimate business purpose (or, after incorporation, conducted business), retained its corporate charter in good standing, and was not merely

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1/ Courts have not, however, always applied Moline in situations where its application was appropriate. See Kurzner v. United States, 413 F.2d 97 (5th Cir. 1969) (where court looked into "corporateness" of incorporated entity instead of simply noting that the corporation must be recognized as such under the Moline doctrine. No mention of Moline.); Garriss Investment Corporation v. Commissioner, T.C.M. 1982-38 (where court considered incorporation under state law to be one of the factors in determining whether corporation whose charter was revoked in 1969 was taxable as such after reincorporation in 1976. No mention of Moline.).

a sham, federal tax law would require recognition of its corporate status. If North Carolina revoked [redacted] corporate charter, [redacted] tax status would be revealed by an analysis under Morrissey and Treas. Reg. § 301.7701-2.

[redacted] does not fit comfortably under either rule. [redacted] corporate charter was suspended but not revoked. And herein lies the crucial issue: Where state sanctions do not terminate the state law existence of a corporation, does a one-man corporation remain a corporation for federal tax purposes until its charter is revoked?

In Lillis v. Commissioner, T.C.M. 1983-142, the taxpayers argued that their 99.83 percent-owned Montana corporation was not in existence during the taxable years in which the business generated certain income. The petitioners attached to their trial brief documents indicating that the corporation's certificate of incorporation had been suspended during the taxable years involved. In dictum, at note 17 of the opinion, the Tax Court wrote:

> These documents do not constitute evidence. Cf. Rule 143(b), Tax Court Rules of Practice and Procedure. Even if they did, the result we reached above would not be different. Under section 35-6-202, Mont. Code Ann. (1981), the restoration of corporate rights pursuant to an application for reinstatement "relates back to the date the corporation was involuntarily dissolved, and the corporation shall be considered to have been an existing legal entity from the date of its original incorporation." Furthermore, suspension of corporate powers, rights, and privileges under section 15-31-523, Mont. Code Ann. (1981), is not equivalent to the dissolution of the corporation. Unless the corporation expires because the articles of incorporation provide that its existence shall only be for a limited period of time, see Mont. Code Ann. §§ 35-1-108(1) and 35-1-1302 (1981), the legal existence of the corporation continues until it is either voluntarily or involuntarily dissolved. See, e.g., Mont. Code Ann. § 35-1-912(2) (1981). See also 16A Fletcher Cyclopedia of Corporations, §§ 7966 and 8113 (1979 rev.). Accordingly, for the years in issue we think there was an entity subject to the tax imposed by section 11....

Id.

Petitioners did not raise the suspension issue prior to filing their memorandum brief in Lillis. Because the Court called for memorandum briefs, respondent had no opportunity to argue the suspension issue on reply. On appeal, the Department of Justice argued that because the corporate charter's later reinstatement related back under Montana law to the date of suspension, the corporation was an existing legal entity from the date of its original incorporation. The Ninth Circuit affirmed Lillis on August 17, 1984, in an unpublished opinion.

In McDonnell v. Commissioner, T.C.M. 1965-125, the taxpayers claimed that their 99 percent-owned Texas corporation ceased to exist after the Secretary of State advised the corporation that by its failure to pay its franchise taxes it had forfeited its right to do business. The taxpayers contended that any losses generated by the business after this date properly belonged to the individual taxpayers, not the corporation. The Commissioner argued that the only effect which the forfeiture of the corporation's right to do business had on the corporation was to prevent it from suing or defending itself in the Texas State courts; in all other respects, the corporation retained the right to do business under its charter. Thus, the corporation's status as a separate taxable entity remained unchanged at least until the date when the corporation's charter was revoked. The Tax Court agreed with the Service, writing:

> A corporation's status, de facto or de jure, is determined by state law when the corporation fails to comply with certain state statutory conditions which affect its right to do business. Langdon L. Skarda, 27 T.C. 137 (1956), affd. 250 F.2d 429 (C.A. 10, 1957). In Isbell v. Gulf Union Oil Co., 209 S.W.2d 762,[sic] (Tex. 1948), the Supreme Court of Texas held that the failure of a Texas corporation to pay its franchise tax merely prevents it from suing or defending itself in the Texas State courts. In all other respects the corporation continues to have the right to do business under its charter.
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> From the foregoing it is apparent that the failure of Lone Star to pay its franchise taxes for the years 1958 to 1963, inclusive, did not affect its corporate entity. It continued to exist as a separate corporate entity until at least March 24, 1964, when the Texas court ordered its charter revoked. This necessarily means that losses incurred by Lone Star prior to the revocation of its charter cannot be utilized by anyone else....

Id.

In Skarda v. Commissioner, 27 T.C. 137 (1956), aff'd, 250 F.2d 429 (10th Cir. 1957), taxpayers, three brothers and their wives, claimed that their New Mexico corporation ceased to exist as a separate taxable entity when the State Corporation Commission of New Mexico notified the corporation that its right to do business in New Mexico was forfeited for failure to file a required annual report. Soon thereafter, the annual report was filed. In seeking to report losses from the failed business on their individual returns, taxpayers contended that the corporation's charter, and therefore its existence, was forfeited along with its right to do business. The Commissioner argued that even if the corporate entity could be considered legally defunct, the organization had continued to conduct its affairs as if

it were a corporation subsequent to the time of the forfeiture, and, therefore, should be taxed as a corporation. We did not address the issue of the effect the forfeiture had on the corporation and its shareholders. Accepting our argument, the Tax Court wrote:

> Chapter 54, section 236, New Mexico Statutes, Annotated (1941), concerning corporations which have forfeited their charter and right to do business under this chapter for failure to make the report, provides:
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> Any corporation in this class may be fully revived by the resumption of actual business and the filing of the annual report contemplated by the provisions of this section.
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> Lynell G. Skarda testified that subsequent to the forfeiture on May 4, 1949, the required report was duly filed. We think this indicated that the petitioners wanted to do everything necessary to maintain the corporate entity. There is nothing in the record to indicate that the business activity of the company was interrupted or changed in the slightest by or after the notice of forfeiture. Whether the company, after the forfeiture of its charter, was a de jure or a de facto corporation, or whether it was merely an association operating in the same form or manner as a corporation, we need not decide. It is sufficient to say that it falls within the classification of entities taxable as corporations under the revenue acts. [Citation omitted.]

Id. at 146-47.

On appeal, the Tenth Circuit wrote:

> Moreover, statutory conditions to the right to engage in business, to be performed after the corporation has been formed, are conditions subsequent, and while a noncompliance therewith may give the state a right to proceed to forfeit the franchise, such noncompliance in the absence of such proceeding does not in anywise affect the legal existence of the corporation. [Citations omitted]

250 F.2d 429, at 435.

The Tax Court in Skarda arguably sheds no light on our issue, because the court begged the question of the corporation's existence under both state and federal law after the state notified the corporation that its right to do business had been forfeited. Note, however, that in Lillis and McDonnell in the Tax Court, and in Skarda in the Tenth Circuit, the courts indicated that where state law sanctions do not result in nonrecognition of the corporation under state law, federal law recognizes the corporation as a separate taxable entity.

The Commissioner's brief in McDonnell contains a statement of Service position on the suspension issue. Therein the Commissioner advocated the same rationale which formed the basis of the Tax Court's opinion: that where state law sanctions do not result in nonrecognition of the corporation under state law, federal law recognizes the corporation as a separate taxable entity. Brief for Respondent at p. 10.

In each of the above three cases the Tax Court decided in the Commissioner's favor that the entity was taxable as a corporation. Although the Tax Court and the Ninth and Tenth Circuits provide the Commissioner with support for his position, other existing precedent originates from the United States District Courts. Young v. United States, 604 F.Supp. 164 (N.D.Okla. 1984); Hair v. United States, 64-1 U.S.T.C. 9206 (S.D.Cal. 1963); Hvidsten v. United States, 185 F.Supp. 856 (D.N.D. 1960).

In Garriss Investment Company v. Commissioner, T.C.M. 1982-38, the Tax Court had the occasion to examine North Carolina law concerning the suspension of a corporation's charter. At issue in Garriss was income from the taxable years 1969-1977. The corporation therein had been granted its charter in May of 1961. In December of 1962, the North Carolina Secretary of State suspended the corporation's charter for failure to file state corporate income and franchise taxes. Under North Carolina law, a corporation may, within 5 years of the date of suspension, reinstate its suspended charter. N.C. Gen. Stat. § 105-232 (1985). The corporation's charter was not reinstated within the five year period. The taxpayer reincorporated the corporation in February of 1976. Taxpayer argued that once the corporation's charter was suspended, the corporation no longer existed as a legal corporate entity, and should not be taxed as such. The Commissioner argued that the corporation was a valid corporation under state law, properly taxable as such throughout the taxable years in issue. The Tax Court agreed with neither party, writing:

> Under North Carolina law, the corporate existence is held in abeyance for a period of 5 years after such suspension. During that period, the corporate charter can be reinstated through compliance with the filing and payment requirements set out in N.C. Gen. Stat. sec. 105-232. If such compliance is forthcoming, the suspension is lifted and erased from the state records. However, if the 5-year period expires without such compliance, the reinstatement privilege is forever lost and the corporation becomes nonexistent. Accordingly, after the 5-year period lapsed in 1967, Garriss Investment Corporation no longer existed as a legal corporate entity under state law. See Knoxville Truck Sales & Service, Inc. v. Commissioner, [Dec. 16336], 10 T.C. 616, 620 (1948). Therefore during and subsequent to the year 1969, it did not enjoy the rights, privileges and protections of corporate status under North Carolina law until its reincorporation in February 1976.9/

> 9/ We need not, and do not, decide whether GIC was a corporation or an association for Federal income tax purposes prior to 1969. ... .

Id. [Emphasis added]

Although the text of the Garriss opinion strongly implies that the Tax Court viewed the corporation as existing under state law during the 5-year reinstatement period, any reliance on Garriss to support this proposition is somewhat hazardous due to footnote 9. The Tax Court was able to avoid the suspension issue since the years before the court did not fall within the 5-year reinstatement period.

Since the taxable years at issue in [redacted] fall within the five-year reinstatement period, we must examine North Carolina law to determine [redacted] state law existence. A North Carolina corporation whose charter has been suspended has at least the following rights:

1. It may bring or defend an action in court;

2. It may take property under a will;

3. It may take and convey valid title to real property.

Parker v. Life Homes, Inc., 22 N.C. App. 297, 206 S.E.2d 344 (1974). See also, Philbin Investments, Inc. v. Orb Enterprises, Ltd., 35 N.C. App. 622, 242 S.E.2d 176 (1975); Raleigh Swimming Pool Company v. Wake Forest Country Club, 11 N.C. App. 715, 182 S.E.2d 273 (1971).2/

2/ Pierce Concrete v. Cannon Realty and Construction Company, 77 N.C. App. 411, 335 S.E.2d 30 (1985) recognizes that the effect of N.C. Gen. Stat. 105-231 is not absolute, and that a corporation whose charter has been suspended has limited rights available to it.

The conclusion thus seems inescapable that a North Carolina corporation whose charter has been suspended remains in existence under state law, albeit with limited rights. Thus, following Lillis, McDonnell, and the Tenth Circuit in Skarda, federal law will continue to tax the entity as a corporation separate from its sole shareholder. Therefore, [redacted] was a distinct entity taxable as a corporation for the years involved.

Sincerely,

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